

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
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In the Matter of )

Price Cap Performance Review )

for Local Exchange Carriers; )

Treatment of Video Dialtone Services )

Under Price Cap Regulation )

CC Docket No. 94-1

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**NYNEX COMMENTS**

The NYNEX Telephone Companies ("NYNEX")<sup>1</sup> submit these Comments in response to the Commission's Further Notice of Proposed Rulemaking ("Notice") released February 15, 1995, in the above-captioned matter.

**I. INTRODUCTION AND NYNEX POSITION**

In its Video Dialtone Reconsideration Order,<sup>2</sup> the Commission stated that LEC VDT offerings would be subject to price cap regulation. The present Notice seeks comment on various issues relative to whether to establish a separate price cap basket for VDT.<sup>3</sup>

NYNEX believes that VDT will be a very competitive new service confronting entrenched cable service and other strong alternative offerings in the market. VDT presents an opportunity for the Commission to permit a new competitive market to develop and produce national economic benefits. The Commission should not only avoid creating new regulatory requirements, but should reduce existing regulatory burdens. The Commission should therefore remove VDT from price cap regulation, and subject VDT to streamlined regulation.

<sup>1</sup> The NYNEX Telephone Companies are New England Telephone and Telegraph Company and New York Telephone Company.

<sup>2</sup> Telephone Company-Cable Television Cross-Ownership Rules, CC Docket No. 87-266, released November 7, 1994 ("VDT Recon. Order"), ¶ 161.

<sup>3</sup> Notice at ¶ 2.

If VDT is initially subjected to price cap regulation, then a new VDT price cap basket should be created, as opposed to integrating VDT into the existing price cap basket structure. While establishment of a separate VDT basket is not needed to prevent cross-subsidy of VDT, it will facilitate a transition to streamlined regulation. It is premature, however, to include other broadband, or transport- or distribution-related services within such a VDT basket, or to create service categories within the VDT basket.

With respect to implementation issues, a productivity factor of zero should apply to the VDT basket; the productivity factors for other baskets need not be adjusted; and no consumer productivity dividend should be applied to the VDT basket.

Consistent with the Commission's treatment of other new services under price caps, VDT service should be folded into the VDT basket at the first annual access filing following the calendar year in which the service was first offered. The VDT basket should be initiated with the price cap index ("PCI") equal to the actual price index ("API") and equal to 100 prior to adjusting for inflation, and should reflect rates in effect at the time of folding VDT into price caps. The Commission should not require more onerous cost justification for VDT tariffs than other new service filings.

Finally, VDT direct costs and revenues should be excluded from the calculation of LECs' interstate rate of return for purposes of the sharing and low end adjustment mechanisms. Such exclusion would obviate any remaining concerns about potential cross-subsidy of VDT.

## **II. GENERAL ISSUES REGARDING ESTABLISHMENT OF A SEPARATE PRICE CAP BASKET FOR VIDEO DIALTONE**

### **A. Attainment Of The Commission's Procompetitive Goals**

The Commission seeks comment on whether and how establishment of a separate price cap basket for VDT service will advance the Commission's goals including facilitating

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competition in the provision of video services, promoting infrastructure investment and ensuring reasonable rates.<sup>4</sup>

The Commission should find that VDT will be a very competitive new service that, together with the provision of video programming, will offer an alternative to monopoly cable service. VDT will also confront strong competition from direct broadcast satellite providers, established broadcasters, and the ubiquitous video sales and rental industry. Since VDT will be a fledgling start-up service facing powerful competition, VDT should not be subject to price cap rate regulation. Telephone companies should be allowed to file informational tariffs for VDT similar to procedures applying to competitive access providers and other competitors.

The Commission's key public interest goal in VDT proceedings has been to foster additional competition in the provision of video services, "so that free market forces, rather than governmental regulation, determine the success or failure of new services."<sup>5</sup> However, the promise of additional competition can only become a reality if regulatory barriers hobbling the telephone companies, and insulating the cable companies, are eliminated.

The Commission's 1994 Annual Report to Congress has confirmed that there is little evidence of increased competition in the delivery of video programming.<sup>6</sup> While the Commission has granted a number of VDT Section 214 Applications, commercial VDT service is still not available to consumers, even 2½ years after the VDT Order. This delay is partly due to the extremely detailed and multi-layered regulatory scrutiny imposed upon telephone

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<sup>4</sup> Notice at ¶ 8.

<sup>5</sup> Telephone Company-Cable Television Cross-Ownership Rules, CC Docket No. 87-266, Second Report and Order, 7 FCC Rcd. 5781 (1992) ("VDT Order"), ¶ 9. See also NYNEX VDT Section 214 Order And Authorization, File Nos. 6982-83, released March 6, 1995, ¶ 95.

<sup>6</sup> Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, CS Docket No. 94-48, First Report released September 28, 1994, ¶ 13: "Cable systems continued to have substantial market power at the local distribution level."

companies, including the Section 214 process, the Part 69 waiver requirement and the tariff filing process.

The Commission's regulatory processes should ensure parity between the VDT and cable industries so that the outcome of competition is dictated by the market, and not by government regulatory handicaps. Under the Cable Act,<sup>7</sup> once alternative video distribution services are present in the cable operator's market ("effective competition"), the cable operator is no longer subject to rate regulation. In contrast, the new market entrants -- telephone companies trying to offer VDT -- are subjected to the time consuming regulatory procedures indicated above.

**B. Creation Of A Separate Price Cap Basket For VDT**

The Commission requests comment on whether it should create a separate price cap basket for VDT, and whether such a basket would ensure against cross-subsidy of VDT.<sup>8</sup>

If the Commission continues to find price cap regulation appropriate for VDT, NYNEX recommends the use of a separate VDT basket. Creation of such a basket will facilitate the transition to streamlined regulation for VDT as a competitive service when the Commission deems it appropriate.

A separate VDT basket is not necessary to guard against cross-subsidy of VDT. As in the case of any other new interstate access service, the Commission's rules require that VDT rates cover direct costs and allocated common and overhead costs.<sup>9</sup> In this regard, the Commission's rules go beyond what is necessary to preclude economic cross-subsidy. As long as VDT rates cover incremental costs, there is no economic cross-subsidy of VDT.

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<sup>7</sup> Cable Television Consumer Protection and Competition Act of 1992, Regulation of Rates, 47 U.S.C. Section 543.

<sup>8</sup> Notice at ¶¶ 8-9.

<sup>9</sup> See VDT Recon. Order at ¶¶ 205-21.

Furthermore, as the Commission has stated:

Under price caps, a LEC has no guarantee that it will be able to recover increased costs in telephone rates. Its incentive to “shift” costs from video dialtone to regulated telephone services is thus greatly reduced.<sup>10</sup>

Moreover, the Commission has already found that:

our existing rules adequately protect consumers against improper cross-subsidy and anti-competitive activity .... [W]e reject requests for adoption of video dialtone-specific accounting, cost allocation, separations, and pricing rules ....<sup>11</sup>

The Commission also seeks comment on whether any new VDT price cap basket should include other broadband, transport-related services.<sup>12</sup> Broadband is not a service per se. It is an architecture which can carry a variety of services. Some of these services are already regulated under existing price cap rules; other, future services using the proposed broadband distribution architecture are not yet known in terms of type, structure and packaging. It is therefore premature to establish a “broadband” basket including VDT and other transport- or distribution-type services utilizing broadband facilities.

Finally, VDT should not be integrated into the existing price cap basket structure.<sup>13</sup> Such integration would prove very difficult to administer to the extent VDT is treated differently in terms of productivity factor, sharing/low end adjustment, etc.<sup>14</sup> For example, LEC interexchange services have been subject to a different productivity factor (3.0%) than LEC interstate access services (3.3%). Administration of that different productivity factor, e.g., in the context of price

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<sup>10</sup> Id. at ¶ 166.

<sup>11</sup> Id. at ¶ 169.

<sup>12</sup> Notice at ¶ 12.

<sup>13</sup> See id. at ¶ 13.

<sup>14</sup> See infra.

cap index ("PCI") changes for each basket, has been simplified by the fact that LEC interexchange services are in a separate price cap basket.

### **III. IMPLEMENTATION ISSUES REGARDING A VDT PRICE CAP BASKET**

#### **A. Productivity Factor**

The Commission requests comment on the appropriate formula to be used to adjust the PCI for a VDT price cap basket. Specifically, the Commission requests comment on the determination of an appropriate productivity factor for a VDT basket.<sup>15</sup> If the Commission subjects VDT to price caps, then a new VDT basket should be created with a productivity factor of 0.0%.

The productivity factors employed in the other price cap baskets are not appropriate for a VDT basket. The selection of a productivity factor for a given set of price cap services has traditionally been based on historical data on productivity for those services. The 3.3% productivity factor used in the original price cap plan<sup>16</sup> was based on the historical productivity of LEC interstate access services.<sup>17</sup> However, since VDT is an emerging new service, no historical data exist which can be used to determine an appropriate productivity factor for this service.

The absence of historical productivity data was a factor in the Commission's decision not to adopt a productivity factor for cable services. The Commission concluded in MM Docket No. 93-215 that the record did not provide an adequate factual basis for incorporating a productivity

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<sup>15</sup> Notice at ¶ 16.

<sup>16</sup> The Commission recently revised this factor to 4.0%, and replaced GNP-PI with GDP-PI as the inflation measure. CC Docket No. 94-1, First Report and Order released April 7, 1995 ¶¶ 19, 351.

<sup>17</sup> The 3.0% productivity factor for LEC interexchange services was based on historical data on competing AT&T interexchange activities. Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order released October 4, 1990, 5 FCC Rcd. 6786 ("LEC Price Cap Order"), ¶ 207.

offset to the GNP-PI in the price cap governing cable service rates.<sup>18</sup> Throughout the cable proceeding, the Commission indicated that any productivity offset should be based to the extent possible on observed efficiency gains experienced by the cable industry. The same approach should be followed regarding any productivity offset for VDT service.

The Commission also requests comment on whether adjustments might be needed to the other price cap baskets arising from the price cap LECs' more efficient use of common plant, and shared expenses between VDT and pre-existing services.<sup>19</sup> There is no basis for any adjustments to the other price cap baskets as a result of the introduction of VDT. At this point VDT is a nascent service. There are no historical data to estimate any potential effects of VDT on access productivity.

Additionally, the Commission requests comment on whether a Consumer Productivity Dividend (CPD) should be included in the productivity factor for the VDT basket.<sup>20</sup> A CPD should not be applied to the productivity factor for the VDT basket.

In the original LEC price cap plan, the Commission added a CPD of 0.5% to the productivity factor for traditional LEC interstate access services in order to "assure that the first benefits of price caps flow to customers in the form of reduced rates."<sup>21</sup> This consideration is inapplicable to VDT. LEC rates under price caps were initialized using access service prices set under the FCC's replaced system of rate of return regulation, which entailed some inefficiencies. But VDT will be offered at prices set under the FCC's new service rules which encourage efficient prices at the outset. Further, VDT will be offered in a market where fierce competition will provide additional assurance of efficient pricing levels.

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<sup>18</sup> Order released September 29, 1994 at ¶ 1.

<sup>19</sup> Notice at ¶ 16.

<sup>20</sup> *Id.*

<sup>21</sup> LEC Price Cap Order at ¶ 100.

Including a CPD in the productivity factor for VDT would also be a departure from the investment and efficiency incentives that exist in competitive markets where firms do not usually share the benefits of above-average productivity performance with their customers.<sup>22</sup>

**B. Setting The Initial Price Cap**

NYNEX agrees with the new services administrative procedures for establishing the initial price cap for the VDT basket as proposed by the Commission.<sup>23</sup> That is, VDT rates would be incorporated into the VDT basket and reflected in the PCI at the first annual price cap filing following the calendar year in which VDT service was first offered. Also, the PCI and API would be set initially at 100 using the rates in effect just prior to the effective date of the annual filing in which the VDT basket is introduced.

While NYNEX agrees with the technical methods proposed for establishing the VDT basket index, we are concerned about the initial rate levels at which VDT services may be brought into the price cap basket. Specifically, the requirements for justification of overhead loadings with respect to initial VDT rates, as set forth in the Commission's guidance in the VDT Recon. Order (§ 220), may prove to be too burdensome and contentious in application. Such loadings could impede the timely introduction of VDT services at prices that will best promote competition.

The current pricing rules for new interstate access services allow initial rates to range between a floor based on direct costs and a ceiling based on fully distributed costs plus a "risk premium." These same boundaries should be used to assess the "reasonableness" of VDT prices. That is, any overhead loadings that result in VDT rates in this range should be accepted as

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<sup>22</sup> See USTA Comments in CC Docket No. 94-1, submitted May 9, 1994, Attachment 2 - Experts' Reports on LEC Price Cap Reforms, Professor Robert G. Harris, p. 25, Section E - Productivity Adjustment Factor.

<sup>23</sup> Notice at §§ 17-19.



“reasonable” without extensive justification for the exact level chosen. The LECs must consider market factors (competitors’ prices, programmer-customers’ service prices, end user demand, etc.) to estimate how much overhead can actually be recovered in VDT rates. The Commission should not let LEC competitors use the overhead issue in the tariff filing process to delay VDT offerings or force into LEC VDT prices uneconomic overhead loadings that would thwart competition at the outset. As the Commission noted in the VDT Recon. Order (¶ 220):

We hope and expect that video dialtone will be a successful service in the marketplace .... [I]mposing excessive cost burdens on video dialtone could diminish demand and possibly overall revenues and thereby thwart these objectives.

In short, the new services rules for initial VDT rates should be no more burdensome or stringent than the new services rules for other interstate access services.

#### **C. Service Category Bands**

The Commission seeks comment on whether VDT may require separate service categories if there is a separate VDT basket.<sup>24</sup> NYNEX believes that service categories are inappropriate since, first, they would impair pricing flexibility needed to compete in this contentious market. Second, the creation of service categories would depend upon how VDT rates are structured; but the Commission has not, nor should it prescribe rate structures for VDT, given the wide variation in how LECs may provide this service in response to market needs.

#### **D. Sharing And Low End Adjustment**

The Commission requests comment on whether the costs and revenues associated with VDT should be included in the calculation of a LEC’s interstate rate of return for purposes of the sharing and low end adjustment mechanisms.<sup>25</sup>

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<sup>24</sup> Notice at ¶ 20.

<sup>25</sup> Notice at ¶ 25.

In order to alleviate any concerns that may remain regarding potential cross-subsidy of VDT, NYNEX recommends that VDT direct costs and revenues not be included in the calculation of a LEC's interstate rate of return for purposes of the sharing and low end adjustment mechanisms. Removing VDT direct costs and revenues from the sharing calculation will break any link between VDT and charges for other interstate access services.

#### IV. CONCLUSION

Video dialtone is a nascent service which will face strong competition from entrenched cable monopolies and others. The Commission should strive for evenhanded regulation of competitors, and make sure VDT is not burdened with regulatory requirements that could cripple the service. Accordingly, the Commission should apply streamlined regulation to VDT as soon as possible. If the Commission applies price cap regulation to VDT, then the initial creation of a separate VDT price cap basket with a productivity factor of 0.0%, as proposed by NYNEX herein, should facilitate a transition to streamlined regulation.

Respectfully submitted,

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